March 23, 2006

Honorable Mayor and City Council:

The City of Scottsdale Proposed Budget for fiscal year 2006/07 funds City Council and citizen priorities, including the hiring of additional police officers, opening new City facilities to meet demands for services, focusing on code enforcement and property maintenance, and continuing the City's emphasis on economic vitality and revitalization of the downtown and the southern area of the community.

Current economic conditions allow the City to maintain core services and, in some cases, to provide enhancements to existing service levels. However, prudent long-term fiscal planning dictates that we remain conservative, focus on the highest Council and citizen priorities, and fund only those enhancements we can sustain financially. The City cannot rely on erratic or short-lived revenues to support ongoing programs.

The revenue forecasts used in this budget are "cautiously optimistic." While conditions continue to improve, the staff has not assumed that the City has returned to the exceptional economic conditions of the 1990s. The community is past its historic period of peak expansion and our long-term budget plans must recognize that fact.

In planning for expenditures, the City staff continued to use a zero-based, "program budget" approach. The program budget focuses on the total cost and quality of each service provided, whether one department or several departments provide the service. The staff also continued to refine plans for continued investment in the City's basic infrastructure and public facilities that address the City's greatest needs and highest priorities. This analysis considered the long-term fiscal impacts of operating costs associated with new capital facilities. The staff continued to proactively assess capital maintenance needs to avoid the long-term and more costly consequences of deferred maintenance for City facilities. This balanced approach to capital investment allows us to strategically plan for future capital needs while addressing our current capital obligations in a cost-effective and rational manner.

How the proposed budget would affect citizens and taxpayers

The City strives to meet citizen requests for enhanced services and federal mandates while holding costs down. The following items provide a summary of the proposed tax and fee changes that will directly impact citizens or taxpayers in the coming fiscal year:

The property tax rate will decrease. For the ninth consecutive year, the City's estimated combined property tax rate will decrease. For FY 2006/07, the budget proposes a decrease of 1 cent in the combined property tax rate, from $1.04 to $1.03 per $100 of assessed valuation. The proposed rate is 47 cents, or 31 percent, below the City's $1.50 financial policy limit initiated with the Bond 2000 authorization.

The lower tax rate stems from a combination of rising assessed valuations and effective debt management. The City uses a balanced mix of long-term debt and pay-as-you go funding to "smooth" the overall tax burden and help ensure taxpayers who will use City facilities today and those who will use them in the future contribute equitably for their costs.

The overall effect on citizens' tax bills will depend mainly on tax rates set by other governments and changes in the assessed valuation of each property. Taxes paid to local school districts comprise the largest portion of property tax bills, and City property taxes are about 10 percent of the total. **In addition, although many owners were notified of higher property valuations in February 2006, the new valuations will not be used to calculate property tax rates until the 2007/08 fiscal year. The proposed 2006/07 budget relies on current valuations.**

Utility charges will increase. The typical homeowner's combined bill for water, sewer, refuse, and recycling services will increase about $2.83 per month or 4.3 percent, if the proposed water, sewer and solid waste rates are adopted. Federal health and environmental requirements are a significant factor in water rate increases. They are the primary reason for several major capital projects, including upgrades to the CAP Treatment Plant and arsenic mitigation facilities. Other cost drivers include increased prices for power to operate plants and chemicals for water treatment.

Budget timing and state legislation

This proposed budget does <u>not</u> account for any potential legislative changes that could adversely affect the final FY 2006/07 adopted budget or future year financial forecasts for the following items:

<u>State-Shared Revenues</u> – any proposed modifications to the allocation of state-shared revenues to local jurisdictions. However, the proposed budget does assume the mid-decade Census of Maricopa County will adversely affect the City's General Fund state-shared revenues by an estimated $2.0 million in FY 2006/07. Faster-growing cities and towns within the state will receive an increased proportion of the overall pool of state-shared revenues based on their population growth.

<u>Property Tax Assessments</u> – any proposed modifications that would change the current limits placed on our annual property tax levy. Changes would likely affect the City's FY 2006/07 budget or future year financial forecasts.

<u>Photo Enforcement</u> – any proposed changes that could negatively impact revenues and operating expenses associated with the City's pilot photo enforcement program on the Loop 101 Freeway.

The staff will continue to monitor the state's budget proposals and assess the impact of any proposed changes on the City.

Base expenditure limit election

The proposed budget does <u>not</u> factor in any potential fiscal impacts or service level modifications that may be necessary as a result of the May 16 vote on an adjusted expenditure base for Scottsdale.

The tentative budget adoption, which sets the City's maximum annual expenditure limit, is scheduled to take place on May 15. Therefore, the proposed budget sets the expenditures at a level that provides the City Council with the greatest range of flexibility permitted under the state law. Based on the results of the May 16 election and prior to the June 6 final budget adoption, the Council will have the ability, if necessary, to adjust the budget in order to comply with the requirements of the state-mandated expenditure limit.

Total employees and compensation for all funds

From a Citywide perspective, <u>for all funds</u>, the proposed FY 2006/07 budget includes 82 new positions at an estimated cost of $3.9 million. With these new positions the City will have the equivalent of 2,708 full-time positions. This "full-time equivalent," or FTE, includes both full-time and part-time positions and 28 contract employee positions being converted to regular City positions to comply with legal requirements. The cost to convert these positions is negligible.

The total budgeted compensation for all employees for the fiscal year, including market and merit pay adjustments and all proposed benefit cost changes, equals $202.2 million, about 55 percent of the operating budget.

Key compensation cost increases <u>for all funds</u> include the following:

- $5.1 million for the proposed 3 percent market adjustment for City employees.
- $2.6 million for merit increases of up to 5 percent for all eligible employees.

- $1.3 million for the City's contributions to the Arizona State Public Safety Retirement System for the City's 426 sworn police and 232 sworn fire FTEs.
- $0.8 million for additional City contributions to the Arizona State Retirement System for the 2,050 civilian FTEs in the system.
- $3.0 million in increased costs for the City's contributions to employee health care benefits. This amount was based on the proposal presented to the Council March 21 and will change depending on the Council's final decision regarding the amount the City will contribute toward health benefit costs.

Components of the Proposed Budget

The proposed budget includes balanced five-year financial plans for each of the City's funds, emphasizing long-term fiscal planning. The budget also includes individual budgets for the City's more than 180 programs. The goal of the program budget is to provide the City Council, citizens, and other stakeholders a more focused analysis of the costs of each City service or function, whether the service is provided by one department or through the combined efforts of several service areas. Each program budget includes a program description, services provided, City Council Goals supported by the program, a multi-year summary of budget and staffing, customers, program goals and objectives and performance measures. The proposed budget also includes a detailed summary of the proposed FY 2006/07 capital budget.

The following is a summary of budget highlights by fund.

General Fund Revenues

The General Fund supports core services and is the largest fund with the greatest potential for revenue fluctuations. General Fund revenue estimates are conservative.

New General Fund revenues and transfers-in equal $264.9 million, an increase of approximately $0.8 million, or 0.3 percent, from the FY 2005/06 year-end forecast of $264.1million.

This comparatively small increase in the forecasted General Fund revenues reflects an accounting change the City made because of a recent internal audit recommendation. A more comprehensive description of this change is addressed in the paragraphs below on the Transient Occupancy Tax. Without this accounting change, the total General Fund revenues would have increased approximately $8.3 million, or 3.1 percent, over the prior year.

The total resources used to fund the City's proposed FY 2006/07 General Fund budget are a combination of forecasted revenues for the coming year and a carryover of unused prior year financial resources. The projected carryover for FY 2006/07 is $32.0 million and includes savings by City departments, greater than anticipated revenues from FY 2005/06, and unused revenue generated from "one-time" construction-related revenue sources to cover "one-time" capital expenditures. The total available resources equal $296.9 million. A discussion of the effects of the carryover on General Fund revenue and expenditure totals is on page vii.

The following General Fund revenues represent the most significant changes between fiscal years:

<u>Transaction Privilege Tax, or "Sales Tax"</u> – Scottsdale's total City sales tax rate is 1.65 percent. Of that amount, .55 percent is dedicated to the specific purposes related to transportation and preservation, which are accounted for in Special Revenue Funds. These revenues and their uses are explained later in this transmittal. The 1.10 percent of the sales tax accounted for in the General Fund is available to fund basic municipal services such as police, fire, libraries, and parks. This general-purpose sales tax is the City's single largest revenue source. In FY 2006/07, it is projected to increase an estimated 6.5 percent, or $7.4 million, to $121.3 million. It is considered an "elastic" revenue source susceptible to peaks and valleys, based on events in the national, state and local economies. Beyond FY 2006/07, the five-year financial plan projections reflect a stable 6.0 percent increase in sales taxes – essentially keeping slightly ahead of a projected modest inflation rate.

Property Taxes – This revenue source is one of the few stable General Fund revenues and is anticipated to increase by $1.4 million, or 7.3 percent over FY 2005/06, to $20.1 million. The increase in revenue is driven by a combination of growth in new construction, up 5.4 percent, and the "primary" assessed values for existing property, up 4.1 percent. The estimates for FY 2006/07 and beyond do not factor in any potential reductions resulting from legislative changes that may result from proposed modifications to the current limits placed on the City's annual property tax levy.

Transient Occupancy Tax, the Hotel "Bed Tax" – During FY 2005/06 the bed tax revenue continued its recovery and the FY 2006/07 forecast assumes the tourism industry will post a solid performance in the coming year. Bed tax revenue is expected to increase by more than $0.4 million, or 4.5 percent, from the FY 2005/06 year-end forecast of $8.9 million to nearly $9.3 million. Based on an internal audit recommendation, 80 percent, or more than $7.4 million, of the total bed tax revenue will be budgeted in the Special Revenue-Special Programs Fund to reflect the restricted nature of this revenue. By City ordinance, 80 percent of this tax revenue is restricted for tourism and hospitality purposes and the payment of contracts to increase tourism and fund debt service for destination attractions. The FY 2006/07 General Fund budget reflects only 20 percent, or $1.9 million, of the projected total bed tax revenue. The forecast assumes a moderate 4.0 percent growth in this revenue source beyond FY 2006/07.

State-Shared Revenues, or "Intergovernmental Revenues" – These revenues are derived from state sales and income taxes shared with Arizona cities and towns, based on a statutorily determined formula, primarily driven by population. The shared sales tax revenue projection is based on continued modest statewide economic growth. The shared income tax revenue projection reflects a two-year lag between the time citizens file their state taxes and the date the revenues are sent to cities and towns. In FY 2006/07, the state-shared revenues are expected to decrease about $0.7 million or 1.7 percent, from $42.2 million in FY 2005/06 to $41.5 million. The projected decline is based on the anticipated adverse impact of the mid-decade Census of Maricopa County on the City's state-shared revenues, as faster growing cities and towns receive an increased proportion of the overall pool of state-shared revenues. Also, these two revenue estimates do not factor in any potential reductions resulting from legislative changes in FY 2006/07 and beyond.

Development Permits and Fees – This revenue is expected to be $17.0 million in FY 2006/07, which represents a decrease of $2.0 million from the projected FY 2005/06 year-end estimate of $19.0 million. The FY 2006/07 forecast assumes revenues will return to normal market conditions. This revenue source is very unpredictable and can have dramatic peaks and valleys from year to year. The staff continues to conservatively forecast a slight slowdown in development and construction during the coming fiscal year and modest declines over the five years of the fiscal plan, as the city reaches buildout.

Fines and Forfeitures – This revenue source includes court fines, parking fines, Photo Enforcement Program revenues (including $2.0 million for continuing the Loop 101 pilot program) and library fines and fees. This revenue is anticipated to increase approximately $0.1 million, or 0.9 percent, over the projected 2005/06 year end amount of $10.7 million to $10.8 million in FY 2006/07. As previously noted, the Photo Enforcement revenue does not factor in any potential reductions resulting from legislative changes in FY 2006/07 and beyond.

General Fund Expenditures

Under the proposed FY 2006/07 budget, General Fund expenditures, debt payments and transfers-out of the fund are projected to be $291.9 million, an increase of $29.0 million or 11.0 percent from the forecasted FY 2005/06 year-end amount of $262.9 million. A major component of the increase is a transfer out to the capital project fund, which is funded primarily with carryover from the current fiscal year.

Details on proposed new staff positions and on selected expenditures are provided below:

New Staff Positions – As a general rule, most of the new FTE (full time equivalent – based on 2,080 work hours per year) positions assume a hire date of September 1 or later. Many hire dates are staggered throughout the fiscal year, when possible, to minimize the initial fiscal year impact. The proposed General Fund budget includes approximately 62 new full-time equivalent positions (FTEs) at an estimated net cost of nearly $2.9 million. The new staff positions are listed in the four service categories noted below:

- Community Facilities – The positions in this category are necessary to staff new or expanded capital facilities primarily constructed with voter-approved Bond 2000 funding. The proposed budget includes 14.81 FTE positions associated with these facilities at slightly under $0.6 million in payroll and benefits costs. The McDowell Mountain Ranch Park and Aquatic Center will require 7.31 FTEs after opening in July 2006. Expansions at Chaparral Park and Scottsdale Ranch Park will require 2.75 FTEs and 0.75 FTE, respectively, to address the anticipated increased recreation and maintenance demands. The Facilities Maintenance Program will also require 3.00 FTEs to handle the added facilities and the Downtown Parking Program will need 1.00 FTE to handle increased service demands associated with the new parking structures.
- Public Safety/Police - All of the proposed staff additions in this category are Police Department positions. The proposed budget includes 26.50 FTE positions at approximately $1.0 million in payroll and benefits costs. They include a combination of sworn (15.00 FTEs) and civilian (11.50 FTEs) positions. These positions are distributed among several programs. Most are in Patrol Services (12.00 sworn FTEs and 4.00 civilian FTEs). Others are detention supervisors (3.00 FTEs civilian), and mounted patrol officers (2.00 sworn FTEs). A sworn position (1.00 FTE) is proposed to support the Surveillance/SWAT team. The balance of the proposed staff increases are all civilian -- Police Records (1.00 FTE), Crime Laboratory (1.00 FTE), Crime Scene Processing (1.00 FTE), Property and Evidence (0.50 FTE), and Internal Affairs (1.00 FTE).
- Citizen Services and Community Growth – The need for positions in this category stems from customer service demands, growth in the community, and federal and state environmental regulations. The proposed budget includes 15.07 FTE positions at a net payroll and benefits cost of less than $0.9 million.

  The largest proposed staff increase is in the area of Planning and Development Services (9.00 FTEs) to address the increased planning and development related workload. The other 6.07 FTEs are attributable to increasing service demands in the following areas: Environmental Preservation (1.00 FTE), the Victim's Advocate Program (1.00 FTE), trails and equestrian facilities (0.50 FTE), youth activities and after-school programs at Pima Park (0.37 FTE), Vista del Camino (0.70 FTE), the STOMP program (1.00 FTE), the Tax Audit Division (1.00 FTE) and facilities maintenance (0.50 FTE, conversion of a part-time to a full-time position).

  The proposed General Fund budget also includes the conversion of existing contract workers in these areas to City staff in FY 2006/07 equal to 25.00 FTEs. These individuals are currently performing services for the City. The conversions are based on a sustainable workload. The associated net fiscal impact of converting these positions is less than $60,000 next year.
- Internal Service Demands – The added positions in this category are driven by a combination of internal and external customer service demands. The proposed budget includes 5.50 FTEs at a net payroll and benefits cost of approximately $0.4 million. The proposed budget adds staff in the Information Systems (3.00 FTEs), Financial Services (1.00 FTE) and Human Resources (1.00 FTE) departments. The budget also includes the conversion of part-time clerical positions in the City Attorney's Office and Capital Project Management to a full-time and a three-quarter-time position, respectively, for a total increase of 0.50 FTE.

Employee compensation. The proposed 3.0 percent cost of living adjustment means an increase of approximately $4.3 million in the General Fund.

Health care costs. The proposed General Fund budget assumes net increases in health care costs in the coming year of approximately $2.5 million under the March 21 plan presented to the Council. This number, like the Citywide costs to all funds, will depend on the Council's final decision on rates.

Retirement costs**.** Arizona State Retirement System costs for civilian employees in the General Fund will increase by about $0.6 million in FY 2006/07 to pay for the City's share in higher contribution rates for the retirement system. The increase in General Fund costs for the Arizona State Public Safety Retirement system is $1.3 million – the same amount as the cost across all funds. All public safety personnel costs are included in the General Fund.

Culture and Tourism – The proposed budget includes a 3.0 percent, or approximately $88,500, increase for the Scottsdale Cultural Council contract and a 7.2 percent, or $0.4 million, increase for the Scottsdale Convention and Visitors Bureau contract.

Ethics Program – The proposed budget includes $250,000 to cover the initial costs of training and processing of complaints related to the City's proposed new ethics policy.

Transfers-Out (debt and capital projects) – The FY 2006/07 proposed budget includes a $45.4 million transfer-out to the CIP Fund for capital projects and for debt service costs. A significant portion of this transfer-out comes from non-recurring construction related revenues and prior year-end expenditure savings. Using these one-time funding sources for capital projects funding is prudent and does not jeopardize the General Fund's reserve or the projected FY 2006/07 year-end unreserved fund balance. Examples of significant transfers-out include funding for capital project costs for SkySong, the ASU Scottsdale Center for Innovation, and the debt service associated with the WestWorld land purchases.

This Proposed Budget does not include recommendations on policy-level items that will be considered by the City Council Budget Subcommittee and/or the full Council. These include a request from the Scottsdale Cultural Council for $538,000 in additional funding, continuation of a downtown marketing program, costs to potentially secure and operate the Villa Monterey Golf Course and other items that may be forthcoming subsequent to the publication of this document.

General Fund Balances and Reserves

The proposed FY 2006/07 budget includes the following:

General Fund Reserve – This reserve, projected to total nearly $30.5 million at the end of 2006/07, continues the City's financial policy of setting aside funds to protect Scottsdale in times of emergency. Most of these funds are carried over from previous years. Once they are spent, it will be extremely difficult to rebuild the reserve. It is financially prudent to have a minimum General Fund Reserve of $26.5 million, an amount equal to 10 percent of annual total operating budget for the General and Transportation funds. For FY 2006/07 the proposed General Fund Reserve continues to include an additional $4.0 million set aside in case the City must pay a settlement in an ongoing tax audit matter. Maintaining this reserve is very important to the municipal credit rating agencies and in retaining the City's triple AAA bond ratings.

Operating Contingency – The proposed budget includes a $2.5 million operating contingency to meet unforeseen expenses during the year. With City Council approval, the contingency allows the City more flexibility to meet any unforeseen costs.

Unreserved Fund Balance – After considering all of the other reserves, an unreserved fund balance of nearly $5.0 million is projected at the end of the 2006/07 fiscal year. These funds are not designated for a specific purpose. The City Council may choose to allocate some or all of these dollars for new or expanded programs or requests, or to allocate them to other reserve funds. For example, these funds can be used to increase City funding for health insurance premium rates, an option suggested by the Council on March 21. The unreserved fund balance represents a combination of accumulated one-time revenues and expenditure savings and would most appropriately be used for one-time expenditures, not to fund new or expanded programs with ongoing operating costs.

Effects of the carryover and summary of "one-time" and ongoing uses

The $32.0 million carryover of "one-time" funds from the current fiscal year (the beginning unreserved balance in the table below) is a key reason why total expenditures in the proposed 2006/07 General Fund budget, at $291.9 million, are higher than projected revenues and transfers-in of $264.9 million. The carryover is also a key reason why the proposed transfer from the General Fund to the Capital Improvement Program Fund this year is substantial – at $45.4 million. Altogether, proposed one-time uses funded from the General Fund total $50.5 million. Ongoing uses total $241.4 million.

The table below reflects the anticipated flow of resources to ongoing and one-time uses in the City's proposed General Fund budget:

	Total Proposed FY 2006/07 (in millions)	**Ongoing uses**	**One-time uses**
Total Resources			
Beginning Unreserved Balance (after adjusting for funding General Fund reserve per Adopted Financial Policy)	**32.0**	-	32.0
Revenues	**246.2**	240.2	6.0 (a)
Transfers In	**18.7**	18.7	-
Total Resources	**296.9**	258.9	38.0
Total Uses			
Dept Expenditures	**229.4**	229.4	-
Debt Service	**6.0**	6.0	-
Transfers Out	**56.5**	6.0	50.5
Total Uses	**291.9**	241.4	50.5
Ending Unreserved Balance	**5.0**		

(a) per the City's adopted financial policies a minimum of 25% of the construction privilege tax revenues are to be transferred to the capital improvement fund each year. For FY 2006/07, the proposed transfer would be $6.0M.

Special Revenue Funds

The City accounts for revenues earmarked for specific purposes – by law or City policy – through special revenue funds.

The Transportation Fund accounts for Highway User Revenue Fund (HURF) dollars shared with cities from state "gas taxes." The fund also includes revenues from the .20 percent Transportation Transaction Privilege Tax (commonly known as the transportation sales tax). The FY 2006/07 HURF revenues are expected to be approximately $15.6 million, which is a modest increase of 3.6 percent, or $0.5 million, over the forecasted FY 2005/06 year-end estimate. The transportation sales tax revenue is projected to increase by about 6.5 percent, or slightly more than $1.3 million, to $22.1 million in FY 2006/07. The forecasted Local Transportation Assistance Fund revenue from the Arizona State Lottery is expected to be essentially the same as FY 2005/06, approximately $1.1 million. Transfers in to the Transportation Fund consist of approximately $2.9 million from the General Fund and $0.3

million from the Solid Waste Fund for alley maintenance costs. Beyond FY 2006/07, the five-year financial plan assumes a stable 6.0 percent increase in the transportation sales tax and a very modest 3.0 percent increase for HURF. The HURF revenue forecast assumes a slight reduction as a result of the mid-decade Census of Maricopa County.

The Transportation Fund operating expenditures and revenue bond debt service are projected to be $31.1 million and are covered by the HURF revenues and 50 percent of the transportation sales tax revenues. The Transportation Department operating expenditures of $14.3 million cover operating costs for master planning, transit services, traffic engineering and other operations. These revenues also support transportation improvements. The Municipal Services Department operating expenditures of $13.6 million cover street and signal operations and maintenance. To address the growth in service demands, the proposed budget includes 3.00 new FTEs at an estimated fiscal impact of slightly more than $0.2 million.

A revenue bond debt service payment of slightly less than $3.2 million represents the final debt service payment for these transportation revenue bonds. The remaining 50 percent of the transportation sales sax, or $11.0 million, is transferred to the Capital Improvement Plan for transportation related capital projects, under this proposed budget.

The Preservation Privilege Tax Fund is used to account for the revenues and expenditures related to the acquisition of the McDowell Sonoran Preserve, which receives funding from the 1995 (0.20 percent) and 2004 (0.15 percent) voter-approved Preservation Transaction Privilege Tax.

Total revenue from the 1995 Preservation Privilege Tax is expected to increase by $1.4 million, or 6.5 percent, from $20.7 million in FY 2005/06 to $22.1 million in FY 2006/07. Revenue from the 2004 Preservation Privilege Tax is anticipated to increase by $1.0 million, or 6.5 percent, to $16.5 million. Beyond FY 2006/07, the five-year financial plan projections reflect a stable 6.0 percent increase in sales taxes.

The Preservation Privilege Tax Fund expenditures and transfers-out of the fund are estimated at nearly $25.1 million for FY 2006/07, compared to $24.6 million in the current fiscal year. The timing and amount of any future preservation bond issuances depends on the availability and price for state lands. Under the sales tax ballot language, the Preservation Privilege Tax revenues are to be used for debt service payments related to preserve acquisition, preserve-related construction and trailheads.

The Special Programs Fund is a collection of smaller restricted revenues dedicated to specific uses. The services included in these various funds are intended to be self-supporting and not subsidized by the General Fund. Examples of these funds include Police Department RICO funds, the City Court's Court Enhancement Fund, the McCormick-Stillman Railroad Park Fund, the Scottsdale Cares Charitable Fund and the Preservation Rehab Fund for historic building rehabilitation.

As a general budgeting practice, all Special Program Fund expenditures reflected in the budget equal 100 percent of the beginning fund balance plus any anticipated revenues in the coming year. This practice creates maximum budget flexibility and reduces the likelihood of using budget contingency for appropriation purposes to comply with state legal requirements.

The Transient Occupancy Tax ("Bed Tax") is the exception to this practice, as the ending fund balance tends to be large and therefore is not budgeted until specific needs are identified. The actual ending fund balance of all Special Program funds is carried forward to future periods and is available to be spent for restricted purposes.

A Special Districts Fund is used to account for the proceeds received from property owners in the City's more than 350 street light districts. All revenue not expended for this specific purpose in the current fiscal year is carried over to the next fiscal year to continue funding the program. The FY 2006/07 Special Districts Fund revenues and expenditures are projected to be nearly $0.6 million.

Enterprise Funds

Enterprise funds account for the City's water, sewer, solid waste collection and aviation services, operated as stand-alone businesses. User fees are assessed to cover the full cost of services.

The Water and Sewer Fund budget continues to be significantly affected by federal health and environmental requirements and federal water quality mandates. The City has worked aggressively to meet federal mandates to reduce arsenic levels in drinking water. The City continues significant efforts to ensure compliance with another forthcoming mandate to reduce levels of by-product compounds from chlorine disinfection.

To help hold down rate increases, the City recently issued $88.4 million in new debt and forecasts the need for additional future debt to meet the capital improvement needs of the Water and Sewer Fund. In this past year, the City began a pilot project to help determine the most effective method to meet federal standards. However, the five-year financial plan still anticipates the need to issue over $100 million in debt to pay for the infrastructure to meet these mandates.

The budget includes a 5.5 percent water fee increase to help pay for these added costs. It also includes future debt of $100 million, to be issued in March 2007, and an increase of 6.0 percent in sewer rates to fund modifications and upgrades to wastewater treatment facilities. These modifications are consistent with the updated five-year financial plan and the adopted Financial Policies. The proposed water and sewer rate increases reflect:

- Capital and associated operating impacts of arsenic and disinfection by-product regulations enacted by the U.S. Environmental Protection Agency (EPA);
- Scottsdale's share of the capital improvements and associated operating impacts at the Multi-City 91st Avenue Wastewater Treatment Plant to serve existing customers;
- Significant price increases in electricity and chemicals; and
- Increasing costs for sewer collection system maintenance to ensure regulatory compliance with new Capacity, Management, Operations and Maintenance (CMOM) regulations that are intended to minimize sewer system overflows.

The proposed rate increases will add $1.36 to the typical residential monthly water charges and $1.11 to the typical residential monthly sewer charges.

While the major costs of the Water and Sewer Fund are capital in nature, the proposed budget includes additional staff to support new and expanded water production and wastewater capital treatment facilities and overall service growth. To address the increased service capacity associated with new capital facilities and growth in service demands, the proposed budget includes 8.50 new FTEs at an estimated fiscal impact of approximately $0.5 million. Based on the proposed budget plan and rate increases, the Water and Sewer Fund will comply with adopted Financial Policies and is expected to maintain a positive fund balance over the five-year financial plan.

The Water and Sewer Fund budget also proposes the conversion of one contract worker (1.00 FTE) to a City employee in FY 2006/07, which would provide for continuity of existing service. There would be no net fiscal impact associated with this conversion.

The proposed FY 2006/07 Solid Waste Fund budget includes a 2.5 percent increase for the operation of refuse collection and recycling services. The proposed increase reflects the combined impacts of salary and benefit cost increases, higher fuel costs and alley maintenance support costs.

Careful planning and management of solid waste operations has allowed operating expense impacts to be absorbed without rate increases since FY 2000/01. The proposed increase for the coming year will add $0.36 to the monthly residential solid waste collection fee. A review of Valley cities providing comparable services indicates that Scottsdale's solid waste collection fee will remain one of the lowest. The Solid Waste Fund will comply with adopted Financial Policies and is expected to maintain a positive fund balance over the five-year financial plan.

The Solid Waste Fund budget proposes 2.00 new FTEs to provide service to the commercial refuse customers. The estimated cost of these positions is approximately $88,000.

The Aviation Fund budget includes no proposed increase in airport landing rates or fees for FY 2006/07. The five-year financial plan projects the fund will comply with adopted Financial Policies and maintain a positive fund balance and not require a General Fund operating subsidy.

The Aviation Fund budget also proposes the conversion of two contract workers (2.00 FTEs) to City employees in FY 2006/07. They are meeting a demonstrated need that will continue indefinitely. There is no net fiscal impact associated with the conversions.

Internal Service Funds

Internal Service Funds account for services and equipment provided to all City departments by centralized divisions, such as maintenance of the City's vehicle fleet and insurance coverage.

The proposed Self-Insurance Fund budget assumes total revenue and transfers-in of $33.8 million. The proposed budget anticipates total operating and claims expenditures and transfers-out of nearly $28.5 million in FY 2006/07. The projected June 30, 2007 total ending fund balance reserve of approximately $22.0 million includes $16.8 million for property casualty, $0.2 million for employee funded short-term disability, and $5.0 million for health benefits. With the addition of a municipal Fire Department in FY 2005/06 and the City's transition to self-insurance, solid reserves are essential to the fiscal stability of the plans.

The proposed Fleet Management Fund forecasts $14.9 million in total revenues and $16.1 million in expenditures and transfers-out for FY 2006/07. The expenditures and transfers-out include $5.9 million for vehicle and equipment acquisitions and $10.0 million for fleet operations. The budget also includes nearly $154,000 for the hiring of 4.00 FTEs in September 2006 to support the new McKellips Service Center. After considering the proposed vehicle acquisitions, staff additions, and operating impacts, which include higher fuel costs, the proposed five-year financial plan for the Fleet Management Fund continues to maintain a fleet replacement reserve based on life cycle fleet analysis.

Debt Service Fund

Debt service funds are designated for payment of long-term debt not directly paid through the General, Enterprise or Special Revenue funds.

Total revenues and transfers-in to these funds are estimated at $58.8 million for FY 2006/07, compared to $59.0 million for FY 2005/06. The secondary property tax levied to pay for voter-approved bonds is the largest revenue source in this fund and is expected to provide approximately $29.6 million in FY 2006/07. The proposed budget projects the "secondary" property tax rate will decrease from approximately 60 cents to 56 cents per $100 of assessed valuation. The secondary portion of property taxes is solely dedicated for the repayment of general obligation bonds.

Debt service funds also receive revenue from special district assessments of $1.1 million, which is used to pay for special district related debt service. The remaining proposed revenues of slightly under $0.4 million are from miscellaneous sources.

A total of $60.0 million is planned for debt service payments in FY 2006/07. The largest scheduled debt service payment is $31.0 million for General Obligation Bonds, including the Bond 2000 program. (In the fall of 2005, the City issued $125.0 million of voter-approved Bond 2000 General Obligation bonds.) The debt service also includes $22.0 million for preserve-related Preservation General Obligation Bonds and Scottsdale Preservation Authority (SPA) Revenue Bonds, $1.1 million for special assessment debt and $5.9 million for Municipal Property Corporation bonds, a transfer-in from the General Fund used for funding SkySong, the ASU Scottsdale Center for Innovation, and WestWorld land purchases.

The budget assumes the City's next General Obligation bond issuance will occur in FY 2007/08 and is currently projected to be $88.1 million. The bonds will provide funding for voter approved

Bond 2000 capital projects such as libraries and parks, neighborhood flood mitigation, scenic corridors, public safety, and transportation.

Capital Improvement Plan

A separate, key component of the annual financial plan is the City's five-year Capital Improvement Plan (CIP) for infrastructure and public facilities – including roads, water and sewer improvements, parks, buildings and information technology. The proposed total CIP appropriation for FY 2006/07 is $863.8 million, which includes $498.6 million (or 57.7 percent of the total) re-budgeted from the prior year. Under Arizona law, the City must re-budget the total budget of a capital project until it is completed and capitalized.

Projects listed in the capital budget are funded by a combination of sources. They include the City's transportation sales tax, Bond 2000 funds, user fees, grants, the Proposition 400 regional transportation sales tax, the City's preservation sales tax, development impact fees and General Fund transfers.

The proposed budget continues the practice of leveraging one-time "elastic" revenue from the General Fund (e.g., construction sales tax and development fees) to help pay for capital projects. Municipal bond rating agencies view this as a sound fiscal practice. The City is not relying on uncertain revenue to pay for ongoing programs. The proposed General Fund transfer into the Capital Project Fund for 2006/07 is $45.4 million.

The capital projects included in the proposed budget are spread throughout the community, with 39 percent north of Indian Bend Road, 24 percent south of Indian Bend, and 13 percent in the McDowell Sonoran Preserve. The remaining 24 percent are considered citywide projects that cannot be tied to a specific area. Additionally, 73 percent of the capital projects budget relates to work on new facilities and 27 percent relates to renovation of community facilities.

Highlights of the proposed capital budget by major project area, along with examples of notable capital projects in each area, are provided below:

Examples of priority projects	(In millions)		
	Rebudgets	New	Total
Community Facilities ▪ Arabian Library Phase II ▪ Appaloosa Library ▪ Scottsdale Road Preservation Streetscape Enhancements ▪ SkySong –ASU Scottsdale Center for Innovation ▪ Chaparral Park Extension ▪ Grayhawk Community Park Phase I ▪ South Ballfields Renovation	$64.0	$56.0	$120.0
Preservation ▪ Gateway to the Preserve Amenities	$205.8	$2.1	$207.9
Drainage & Flood Control ▪ Granite Reef Watershed ▪ Loop 101 Outlet Storm Drain ▪ South Scottsdale Road Drainage Corridor	$20.6	$16.0	$36.6
Public Safety ▪ Fire Station #602 – Downtown Fire Station ▪ Fire Ladder Truck ▪ District 1 Police Facilities ▪ Detention Facility Consolidation ▪ Helicopter Air Support Unit	$49.5	$12.3	$61.8
Service Facilities ▪ City Hall Lagoon Renovation ▪ TPC Stadium Site Access Improvements ▪ TPC Stadium Course Path Access Improvements	$18.1	$18.3	$36.4

Transportation ▪ Pinnacle Peak – Miller to Pima Road ▪ Indian Bend Road - Scottsdale to Hayden ▪ Indian School Road – Drinkwater to Pima Freeway ▪ Stacked 40- North Frontage Road ▪ Pima Road – Deer Valley to Pinnacle Peak ▪ Cactus Road – Pima Freeway to Frank Lloyd Wright ▪ Pima Road – Pima Freeway to Deer Valley ▪ Bikeways Program ▪ Mustang Transit Passenger Facility ▪ McDowell Road Bicycle and Pedestrian Improvements	$114.8	$58.5	$173.3
Water & Sewer Services ▪ Arsenic Mitigation Facilities for the City's Water System ▪ Water Quality Improvements –Southern Neighborhoods ▪ Sewer Collection System Improvements	$25.8	$202.0	$227.8
Totals	**$498.6**	**$365.2**	**$863.8**

Each year the City staff continues to enhance the capital project evaluation and cash management processes to prioritize funding for projects. The proposed five-year CIP uses conservative financial forecasts and reflects only those high priority projects expected to be completed during the next five years. This approach helps the City manage operating costs for new facilities and avoids raising expectations for projects that are not well defined.

The improvements in managing CIP finances are helping the City to manage cash transfers from the General Fund for capital funding purposes. In FY 2006/07, the budget assumes transfers from the General Fund into the CIP of approximately $45.4 million. Of this total amount, $5.3 million will go to general maintenance, $5.6 million will go to public safety radio replacements and the remaining $34.5 million will support capital projects that do not have other dedicated funding sources. The significant increase in General Fund revenues flowing into the Capital Improvement Fund will help the City fund key capital projects now and ensure Scottsdale is well positioned in coming years to draw on its capital funding when the City must meet its commitments to build infrastructure at SkySong, the ASU Scottsdale Center for Innovation.

Conclusion

The information provided in this proposal provides the basis for a comprehensive discussion of the proposed budget over the next few months, when the City Council and the public will have the opportunity to gain more insight into the budget development process and the City's financial picture.

In developing this proposed budget, the staff sought to:

- Use conservative and realistic revenue forecasts – and not rely on one-time construction related revenues to fund ongoing operating budget expenditures.
- Continue to fund needed investment in the City's infrastructure and facilities.
- Limit staff increases to high priority service areas and redeploy existing staff, where possible.
- Limit the City's risk and exposure to high costs in the long-term.
- Use a zero-based program budget approach to justify and control expenditures while still focusing on achieving the City Council's goals and providing basic City services.
- Focus on continuing high priority programs and reduce or eliminate funding to less critical programs.
- Continue to plan for the future through strategic economic development investments that demonstrate a clear return to the community.
- Maintain a prudent level of financial reserves.

It is appropriate to thank the City staff, especially Chief Financial Officer Craig Clifford, Budget Director Art Rullo and the Financial Services staff, who have put much time and expertise into the development of the proposed budget and balanced Five-Year Financial Plan. The staff has been working on this document since adoption of the FY 2005/06 City Budget, when the first steps of this budget review process began. Departments have worked closely with the Financial Services staff and senior management in developing, documenting and reviewing every component of this proposal. The staff has embraced the City Council's goals in building a balanced financial plan that delivers the highest quality services at the most reasonable cost to the residents and businesses of Scottsdale.

The City Council Budget Subcommittee began meeting early this year and many of their insights have been used in developing this proposed budget. Over the coming weeks, the subcommittee and citizens will devote many more hours to understand and analyze the proposed budget, consider citizen, Cultural Council, downtown marketing and individual Council Member requests, and offer their recommendations. Their input is an important part of the budget development process.

On March 28, staff is scheduled to provide City Council with an overview of the proposed operating and capital budgets. On May 2, the Budget Subcommittee will present their comments and recommendations regarding the proposed budget to the full City Council. The City Council will begin its formal review of the budget with the first public budget hearing and tentative budget adoption scheduled for May 15. The second public budget hearing and final budget adoption is planned for June 6.

The City staff and I look forward to a thorough and thoughtful examination of the FY 2006/07 proposed budget.

Janet M. Dolan

City Manager